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Main Street or Bay Street

The Only Choices?

John F. Chant

In this issue...

Sweeping changes in the financial world have brought the Canadian financial services industry to a fork in the road. Down one path — "Bay Street" — is an internationally competitive banking system consisting of a few large banks. Down the other path — "Main Street" — is a banking system that meets domestic competition standards. A third way, however, is "Reciprocity Road": remove one of the remaining barriers to foreign competitors in Canada by establishing reciprocal agreements with other countries, allowing their banks into Canadian retail banking markets through branches.

The Study in Brief

Sweeping changes in the financial world have brought the Canadian financial services industry to a fork in the road. One way is an internationally competitive banking system consisting of a few large banks. The other is a banking system that meets domestic competition standards. The first may not assure vigorous domestic competition, however, while the other may leave Canadian banks too small to compete globally. It would be unfortunate if Canadian policymakers were forced to choose between just these two alternatives. This *Commentary* suggests a middle way that could let Canadian banks be internationally competitive and yet promote domestic competition.

The proposed bank mergers of 1998 previewed the likely concerns of Canadian competition authorities about future mergers. Their reviews made it clear that the merging parties would need to divest themselves of large parts of their business. But few qualified buyers exist who could take over the business parts that must be let go. The middle road creates a framework under which foreign banks might be more willing to be buyers. It might also signal more clearly that they would be treated as suitable buyers.

Under this framework, foreign banks could conduct full banking operations in Canada through their branches, eliminating the need for stand-alone subsidiaries with their associated costs. Prudential concerns about foreign branches could be overcome by a system of mutual reciprocity committing their home country authorities to stand behind those branches, by, for example, extending deposit insurance to cover Canadian depositors. Canada could pursue such a system by proposing a North American banking market or regulatory union, or by declaring a willingness to enter into mutual reciprocity agreements with any other suitably qualified parties.

Although the success of this middle road is not assured, it provides a further option at little cost. If we follow this road and still find few potential buyers, we may need to reconsider our competition standards for banking services.

Canadians feel more passionately about the ownership of banks than about the ownership of airlines, oil and gas, or telecommunications. To preserve a healthy banking system that serves the economy, Canada may need to make strenuous efforts to open it up. This paper suggests one possible way.

The Author of This Issue

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Sweeping changes in the financial world have brought the Canadian financial services industry to a fork in the road. Down one path — we might call it Bay Street — is an internationally competitive banking system consisting of a few large banks. For some financial services, however, Bay Street may not provide the vigorous competition needed to serve Canadians and their businesses well. Down the other path — Main Street — is a banking system that meets domestic competition standards. Main Street, however, may leave Canadian banks too small to compete effectively in the world arena. If the choice is between just these two alternatives, Canadian policymakers face an unpleasant tradeoff.

I suggest, however, that policymakers' choices need not be so limited. A middle road may give Canadian banks the chance to achieve international competitiveness and at the same time promote domestic competition. In this *Commentary*, I propose such an option.

The proposed bank mergers of 1998 previewed the concerns that will be raised by the Canadian competition authorities about future mergers as they come forward. The reviews of those merger proposals made it clear that merging parties would need to divest themselves of large parts of their business to meet those concerns. There might be few buyers both qualified and willing to take over of the business parts that must be let go. The middle road I propose here creates a framework under which foreign banks may be more willing to be buyers when a merger is proposed. It might also signal that they would be treated as suitable buyers when the time came.

Under the framework I propose, foreign banks would be permitted to conduct full banking operations in Canada through their branches. Foreign banks would not need to create stand-alone subsidiaries with separate capital and governance structures in order to carry on full-line banking. Prudential concerns about such branches being outside the purview of Canadian regulators could be overcome by a system of mutual reciprocity, committing the other countries' authorities to providing oversight and protection for Canadian depositors on the same basis as home country[1] customers.

Furthermore, while this middle-road approach (let us call it "Reciprocity Road") would reduce concerns about the impact of major bank mergers on domestic competition by introducing new potential buyers into Canadian banking, it would also create new opportunities for Canadian banks in those countries that accepted Canada's invitation to adopt such a reciprocal arrangement.

The Changing World of Banking

World banking has undergone sweeping change over the past five years. Tables 1 and 2 show that, of the top ten world banks in 1995, only three remained in the top

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1 Throughout this paper, the term "home country" refers to the country where the bank is headquartered; the term "host country" refers to any other country where the bank has operations.

ten just five years later, whether measured by tier 1 capital or by assets. Table 3, which takes account of recent and pending mergers, reveals that every top-ten institution today has engaged in a significant merger or acquisition within the past three years. Even more striking is the fact that, of the ten leaders of 1995, five have merged to form other banks that now lead the league.

This unprecedented wave of mergers has been the major force shaping the world's largest banks. Some earlier US bank mergers, such as Wells Fargo with Norwest and BankAmerica with NationsBank, were part of a general restructuring of US banking set loose by the removal of archaic geographical restrictions. More recent US transactions, especially those of Citigroup, were made possible by the lifting of restrictions on combining banking with insurance and the securities business. The Japanese mergers have a totally different motivation: they are an attempt to shore up an impaired banking system. Finally, the European mergers may be the most significant for the future of world banking: Deutsche Bank, HSBC, and Union Bank of Switzerland appear to be transforming themselves into truly global banks.

The mergers taking place in world banking are important for the future of Canadian banks. They may portend a restructuring of world banking around a small group of dominant global banks, a trend many banking observers have predicted. If so, Canadian banks will need to develop strategies for adapting to that changing environment.

Much evidence indicates that mergers have been and remain the major means by which banks increase their size. Internal growth rarely changes market shares by much. Major Canadian banks themselves were built through successive mergers and takeovers. The national, and possibly global, banks emerging in the United States owe their current positions to recent mergers and acquisitions. These dramatic changes raise questions about the future of Canadian banks. Some will likely renew their proposals for mergers, as part of their strategies to deal with the challenge.

Canadian Banks from a World Perspective

Canadians have come to view their banks as being very large. But that view is correct only from a domestic perspective.

Canadians have come to view their banks as being very large. But that view is correct only from a domestic perspective. Comparing Canada's "big five"[2] with the world's largest banks gives a different picture. The assets of the big five rank only between 55th and 70th in the world banking league. Their average size, whether measured by assets or tier 1 capital, is no more than one-third that of any of the ten largest banks.

Tables 1 and 2 show that, despite many changes in world banking, Canadian banks have managed to hold their places in the rankings over the past five years.[3] They also seem to have managed to increase their relative size somewhat. But though Canadian banks have substantially reworked themselves, their changes pale relative to how the world's largest banks have recently changed. When

2 Royal Bank of Canada, Canadian Imperial Bank of Commerce (CIBC), Bank of Montreal (BMO), Bank of Nova Scotia (Scotiabank), and Toronto-Dominion Bank (TD).

3 This comparison may be misleading; Canadian banks move up in the ratings whenever higher-ranked banks merge.

Table 1: ***Ranking of Major World and Canadian Banks, 1995***

By Tier 1 Capital*			By Assets		
(rank)		*(US$ billions)*	*(rank)*		*(US$ billions)*
1	Sanwa Bank	22.6	1	Sanwa Bank	582
2	Dai-Ichi Kangyo Bank	22.4	2	Dai-Ichi Kangyo Bank	582
3	Fuji Bank	22.2	3	Fuji Bank	571
4	Sumitomo Bank	22.0	4	Sumitomo Bank	566
5	Sakura Bank	21.4	5	Sakura Bank	559
6	Mitsubishi Bank	19.8	6	Mitsubishi Bank	548
7	HSBC	18.0	7	Industrial Bank of Japan	433
8	Crédit Agricole	17.3	8	Norinchukin Bank	429
9	Citicorp	17.2	9	Long-Term Credit Bank of Japan	372
10	Union Bank of Switzerland	16.2	10	Deutsche Bank	368
Average of top 10 world banks		*19.9*			*501*
51	CIBC	6.0	59	Royal Bank	123
54	Royal Bank	5.7	65	CIBC	106
73	Bank of Montreal	4.5	68	Bank of Montreal	99
78	Bank of Nova Scotia	4.4	74	Bank of Nova Scotia	94
83	Toronto-Dominion Bank	4.1	102	Toronto-Dominion Bank	70
Average of top 5 Canadian banks		*4.9*			*98*
Top 5 Canadian banks as % of top 10 world banks		*24.6%*			*19.6%*

* Tier 1 capital as defined by the Bank for International Settlements includes common stock, disclosed reserves, and retained earnings.

Source: *The Banker*, July 1995, pp. 135, 181.

pending mergers and acquisitions are considered, as Table 3 shows, Canadian banks combined are only as big as Citibank and just over half the size of the proposed Mizuho Bank.[4]

Does Size Matter?

The consequences of choosing Main Street over Bay Street depend very much on whether size matters for success in banking. If it does, the choice of Main Street domestic standards means that we can expect Canada's banks to keep falling behind the world's banking leaders. If size does not matter, the choice of Main Street maintains the present state of competition without bearing costs in terms of the global competitiveness of Canadian banks. Still, the proposals I present in this paper make sense whether or not size matters.

It is difficult to find a clear message on the importance of size in banking, at least in terms of the present scale of Canadian banks. Lessons based on the past

4 These size comparisons are no more than a rough gauge because of differences among banking systems. Size comparisons are especially sensitive to movements in exchange rates. The comparison of 2000 with 1995, for example, captures the appreciation of the Canadian dollar relative to the European currencies that are now subsumed under the euro.

Table 2: ***Ranking of Major World and Canadian Banks, 2000***

By Tier 1 Capital[a]			By Assets		
(rank)		*(US$ billions)*	*(rank)*		*(US$ billions)*
1	Citigroup	47.7	1	Deutsche Bank	844
2	BankAmerica	38.2	2	Citibank	736
3	HSBC	28.5	3	BNP Paribas	702
4	Bank of Tokyo / Mitsubishi Bank	26.0	4	Bank of Tokyo / Mitsubishi Bank	678
5	Chase Manhattan Bank	25.5	5	Bank of America	633
6	Dai-Ichi Kangyo Bank	23.5	6	Union Bank of Switzerland	613
7	Crédit Agricole	23.3	7	HSBC	569
8	Sakura Bank	23.1	8	Fuji Bank	531
9	Fuji Bank	22.7	9	Sumitomo Bank	507
10	Industrial & Commercial Bank of China	21.9	10	HypoVereinsbank	506
Average of top 10 world banks		*28.0*			*632*
50	Royal Bank	8.2	55	Royal Bank	178
53	Bank of Nova Scotia	7.8	59	CIBC	163
57	CIBC	7.6	61	Bank of Montreal	152
60	Toronto-Dominion Bank	7.5	66	Bank of Nova Scotia	145
63	Bank of Montreal	7.2	70	Toronto-Dominion Bank	140
Average of top 5 Canadian banks		*7.7*			*156*
Top 5 Canadian banks as % of top 10 world banks		*27.5%*			*24.7%*

[a] Tier 1 capital as defined by the Bank for International Settlements includes common stock, disclosed reserves, and retained earnings.

Source: *The Banker*, July 2000, pp. 178, 214–216.

offer little guidance for a new world in which megabanks will dwarf the banks from which most evidence has come.[5] Moreover, the evidence itself is unclear because of the various ways in which size can matter. Those aspects where size may matter most may not yet have been studied adequately to present clear conclusions.

Santomero and Eckles (2000), in their recent survey of the evidence on the consequences of greater size, identify possible effects of overall size in terms of its impact on operating costs, operating revenues, and the ability to make the large financing commitments necessary to compete globally.

Economists have directed much effort to exploring the effects of scale on costs and, to a lesser degree, revenues. With respect to costs, Santomero and Eckles find that, "[a]lmost universally, the gains from strict cost efficiency are illusory" (2000, 4). With respect to revenue effects, on the other hand, evidence increasingly suggests that benefits from mergers do show up. These benefits, however, usually arise from gaining greater size through combining banking with other business activities; they are less likely to be significant for mergers within banking itself.

5 Although some studies of large international banks are now appearing, most evidence comes from the US experience, which, while satisfying the statistician's craving for large numbers of observations, has concentrated on relatively small sized-banks.

Table 3: *World Bank Rankings by Assets, after Transactions, 2000*

Rank		Assets	Transactions
		(US$ billions)	
1	Mizuho Bank	1,393	Merger of Fuji Bank, Dai-Ichi Kangyo Bank, and Industrial Bank of Japan, September 2000
2	Sakura Bank / Sumitomo Bank	997	Merger, April 2001
3	Deutsche Bank	844	Acquired Bankers Trust, June 1999
4	Bank of Tokyo / Mitsubishi Bank	819	Merged, 1999
5	Citigroup	717	Takeover of Citibank by Travelers Group, 1998
6	BNP Paribas	702	Banque Nationale de Paris acquired Paribas, 1999
7	Chase Manhattan Bank	667	Acquired J.P. Morgan, September 2000
8	Bank of America	632	Merged with Nationsbank, 1998
9	Union Bank of Switzerland	614	Merged with Swiss Bank Corp., June 1998
10	HSBC	569	Acquired Republic New York Corp., December 1999
Average of top 10 world banks		*795.4*	
55	Royal Bank	178	
59	CIBC	164	
61	Bank of Montreal	52	
66	Bank of Nova Scotia	145	
70	Toronto-Dominion Bank	140	Acquired Canada Trust, 1998
Average of top 5 Canadian banks		*155.8*	
Top 5 Canadian banks as % of top 10 world banks		*19.6%*	

Sources: Table 2; and *The Banker*, July 2000, pp. 144–145, 246.

Many of the perceived benefits of larger size are found in areas where there is little empirical evidence. Santomero and Eckles argue most strongly that a bank's size will be important for its global competitiveness:

> Most large-scale financings require substantial book positions which would be impossible in absence of a large balance sheet. This is of increasing relevance today as the nonfinancial industrial structure consolidates globally. The latter trend has forced financial firms to increase the scale of their ownership position in underwritings, syndications and new issues. With the decline in the size of selling groups and increased pressures on comanagers, balance-sheet size becomes a comparative advantage as does distributional capability, which is related to operating scale. (2000, 14.)

To an extent, the economic evidence regarding the benefits of greater size may not be relevant to policymakers in their choice between Main Street and Bay Street. It is normally up to managers acting on behalf of stockholders to determine corporate strategy in the absence of strong public policy concerns. The actions of banks' managements in 1998 indicated their strong belief in the benefits of size. But unease about the adequacy of competition in domestic markets does provide a policy concern with respect to bank mergers. While this unease may in the end block such mergers in the present environment, policymakers should seek options that can resolve or minimize the conflict between Main Street and Bay Street,

especially when corporate management clearly perceives the benefits from greater size.

Banking in the Canadian Economy

Getting policy right with respect to banking is critically important to Canada. A vigorous banking sector has been one of the strengths of the Canadian economy from Confederation onward. Canadian banks have usually operated in a more flexible framework than banks elsewhere. In addition, they attained their size at an early stage through permissive merger policies. This combination of flexibility and size together with Canada's national system of banking, allowed Canadian banks to develop strength in global banking through, among other things, their experiences in managing dispersed branch networks.

Recent Canadian banking policy has attempted to preserve the balance between the strength of the banks and adequate competition in banking services. In particular, banking policy since the 1960s has been characterized by a succession of measures reflecting the "pro-competitive" thrust of the Royal Commission on Banking and Finance (the Porter Commission). That commission was the most thorough study of Canada's financial system, and it provided a blueprint for much of the subsequent banking reform. The 1967 amendment to the *Bank Act* eliminated the ceiling on bank lending rates and disallowed bank agreements on deposit rates.[6] The 1980 amendments opened the entry to foreign bank subsidiaries and removed many of the barriers between financial businesses, allowing banks fully into the mortgage market, and other institutions directly into the payments system. The 1992 amendments removed many remaining distinctions that separated different types of financial institutions.

Parts of Finance Minister Paul Martin's recent package of financial sector reforms continue the tradition. The proposed reforms open the payments system to new players, such as mutual fund companies, insurance companies, and investment dealers, improving their ability to compete for household financial business. The reforms also give major institutions more choice in their institutional structures and allow greater range in ownership options. Most significant for the banks, it repeals the unwritten "big shall not buy big" policy that blocked major mergers from the 1980s onward. The reform formalizes the merger review process for future repeats of the 1998 Royal-BMO and CIBC-TD proposals. On the other hand, it also adds parliamentary hearings to consider different dimensions of the public interest.

Martin's legislation unfortunately does not make future mergers among major banks much more likely to succeed than were the 1998 proposals.

This more open approach to mergers will turn out to be completely hollow, however, if it fails to solve one overshadowing issue — that is, if it fails to reconcile the banks' desires to grow through mergers with the public's need for competition. Martin's legislation unfortunately does not make future mergers among major banks much more likely to succeed than were the 1998 proposals; those met their major roadblock when the competition test found both proposals to cause a "substantial lessening of competition" in a variety of markets.

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6 The 1967 amendments to the *Bank Act* rejected the pro-competitive thrust of the Porter Commission in one dimension by introducing a prohibition on foreign banking in Canada.

To understand the problem facing any future mergers, it is useful to examine the basis of the Competition Bureau's concerns about the mergers.

The Competition Test

The failed mergers left one benefit for similar future proposals through the insights they gave into the workings of the competition test.[7] The review of bank mergers was routine in some dimensions and not in others. The Competition Bureau — Canada's antitrust watchdog —handles merger proposals in other industries by the hundreds. The 1998 bank merger proposals drew forth the bureau's first assessment of mergers among major banks. Anticipating the problems such mergers could pose, the bureau adapted its merger enforcement guidelines to deal with the specific features of banks and their business, and issued the revised guidelines for discussion before the merger review (see Canada 1998a). Without specific application, even those efforts at formulating and clarifying the evaluation criteria left plenty of room for uncertainty and interpretation. Although the mergers never reached the stage of negotiating remedies, the bureau's review provided banks and their watchers with a look at the merger guidelines in practice.

Still, merger reviews are not an end to the process. Would-be merging parties have several options after an unfavorable review. They may seek to have the merger approved by challenging the bureau's finding before the Competition Tribunal, the final authority for competition questions. Alternatively, they can work with the bureau in devising remedies.[8] The most important contribution of the 1998 reviews may be the message they send regarding possible remedies needed to overcome the bureau's concerns.

The most important contribution of the 1998 reviews may be the message they send regarding possible remedies needed to overcome the bureau's concerns.

The bureau's scrutiny ranged over every market in which the participating banks operated. In many markets, the absence of undue lessening of competition could be determined without intensive study. In practice, the bureau narrowed its concerns to the banks' securities business, the credit card business, and branch banking, all of which differ substantially with respect to the severity of the problems they present and the possibility of remedy. Moreover, the two merger proposals raised quite different concerns despite the apparent sameness of the large banks involved.

Securities

The Competition Bureau expressed concern about a substantial lessening of competition in just two submarkets of the securities business. The first — full-service brokerage, defined as securities trading combined with advice — was judged to be local because of the importance of local branch offices in delivering

7 This section is based on letters from the Competition Bureau to the chairs of various Canadian chartered banks. See Canada 1998b; 1998c; 1998d; 2000.

8 The Competition Bureau departed from its normal practice of negotiating remedies by stating that it would simply write its letter identifying areas of concern and would not enter any remedial negotiation unless the minister of finance gave approval.

the services.[9] The other market of concern — equity underwriting for issues greater than $50 million — was judged to be national in scope.

Joining under one roof the full-service brokerage businesses of BMO's Nesbitt Burns and the Royal's RBC Dominion Securities posed the biggest problem in the securities business. The bureau determined that this combination would lessen competition in 39 of the 63 local markets served by both banks, and might lessen competition in a further 16 markets. The joining of TD Evergreen with CIBC's Wood Gundy, in contrast, would lessen competition in only one of the 22 shared markets, with a possible lessening in two others.

The concerns with equity underwriting arose solely from the combination of Nesbitt Burns with RBC Dominion Securities. The bureau's concern here was tentative because of uncertainties about the appropriate way to measure market share. The bureau found that the merging parties had a market share greater than the bureau's critical 35 percent threshold on the basis of a measurement that gave full credit to lead underwriters in determining market share. Still, it concluded that further detailed review was needed before a lessening of competition could be confirmed.

Credit Cards

The credit card business of the banks also posed analytical difficulties because of the range of different activities in this business that, in the bureau's view, constitute separate markets. The Competition Bureau identified the following separate markets:

- the issuing of credit cards to consumers — issuing cards to consumers and taking responsibility for their credit card payments,
- the acquiring of card transactions —paying merchants for transactions for which they have accepted credit cards, and
- the supplying of network services — bringing different card issuers and transaction acquirers together to create a framework though which consumers can use cards to make purchases, and merchants can be reimbursed for their sales.

Issuing

The mergers created little danger of substantially lessening competition in credit card issuing.

The mergers created little danger of substantially lessening competition in credit card issuing. Many Canadian financial institutions — domestic banks, foreign banks, *caisses populaires*, and credit unions — issue credit cards to their customers. Many other card issuers — especially so-called monolines— are in the business of issuing credit cards to customers with whom they do no other business. Furthermore, many consumers hold multiple cards and will be aware of the features and terms offered by different issuers. Taking these and other features into account, the bureau found no competitive problems with respect to card issuing from either merger.

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9 Full-service brokerage is distinguished from discount brokerage, in which trading services are offered without advice.

Acquiring

Acquiring card transactions differs substantially from issuing cards. An acquirer of credit card claims generally must maintain commercial banking relationships with retail businesses that accept cards for payment. This requirement prevents many specialized card-issuing institutions, especially consumer-oriented institutions, from being active in acquiring.[10] Merchants (unlike consumers, who may hold several cards) often confine their business to only two acquirers, one each for Visa and MasterCard. The Competition Bureau examined the impact of the proposed mergers on the market for acquiring from two perspectives: the separate MasterCard and Visa networks and the overall credit card market — so-called primary merchant acquiring.

The shift of BMO's credit card business to Visa would have crippled MasterCard by depriving it of its dominant member.

The bureau foresaw that the two mergers would have quite different impacts on competition with respect to acquiring in the two networks. A shift in BMO's credit card business to Visa was a nonstarter because it would have deprived MasterCard of its major member. The bureau saw no problems for competition within Visa from a shift of the Royal's business to MasterCard because the large number of Visa members meant that one fewer would not lessen competition. In contrast, the CIBC-TD merger would have united two of the top three Visa acquirers, which, in the bureau's view, would have substantially lessened competition within the Visa network.

The primary merchant-acquiring market was more complicated to analyze and, in the bureau's view, raised competitive concerns. The bureau saw the market as undergoing a transition from being local to becoming national. It identified the relevant competitors at the national level as BMO, Scotiabank, CIBC, the Royal, and TD, with the National Bank and Caisses Desjardins as significant competitors in Quebec. Both proposed mergers have taken the resulting combination close to the bureau's critical threshold, possibly resulting in substantially less competition. The two mergers proceeding together would, in the bureau's view, have definitely resulted in a substantial lessening of competition.

Network Services

The Competition Bureau's analysis of competition between networks was strongly influenced by the existing rules of the card networks against membership in both networks — so-called dual membership. These rules meant that the combined Royal-BMO would have had to switch entirely to one or the other network.[11] The shift to Visa of BMO's card business would have crippled MasterCard by depriving it of its dominant member. Only a move by the combined bank to

10 Like many other areas of financial markets, the acquiring market also appears to be changing. First Data, a specialized acquirer from the United States, recently purchased the acquiring business of Canada Trust. In addition, BMO and the Royal have formed a joint venture to provide integrated acquiring services for Visa and MasterCard, allowing merchants to deal with only one acquirer. The implication of this change is discussed below.

11 Although the networks impose these prohibitions themselves, any move to eliminate them would likely raise competitive concerns because of common membership. Dual membership has been the source of much litigation in the United States. See Evans and Schmalensee 1999, 69–70, chap. 8.

MasterCard would ensure adequate competition between networks. No such concern resulted from the CIBC-TD merger because both were members of Visa.

Banking Activities

As a first step in dealing with traditional banking, the Competition Bureau defined the relevant geographic market area for each activity.

As a first step in dealing with traditional banking, the Competition Bureau defined the relevant geographic market area for each activity, distinguishing national, regional, provincial, and local markets. Next, it identified the actual and potential competitors in each market. Finally, the bureau compared the effective competition and market shares after the hypothetical mergers with critical thresholds, and directed a more intensive analysis toward problem markets.

Consumer products served through local branches included personal long-term investments (mutual funds, bonds, and stocks); personal short-term savings (guaranteed investment certificates, money market mutual funds, Canada and provincial savings bonds, and treasury bills); personal transactions accounts; student loans; residential mortgages; and personal loans or lines of credit. The business products identified with branches included term loans, business transactions accounts and related services, and operating loans. The bureau found no problems of competition in many of these markets, often because of the presence of non-bank competitors. The bureau found that each merger would lead to a substantial lessening of competition in the markets for the following local market services: transactions accounts, residential mortgages, and personal loans or lines of credit, for consumers; and business transactions accounts and operating loans, for businesses.

The bureau's review showed that the Royal-BMO merger would have resulted in a definite lessening of competition in 104 of the 224 local markets in which both banks operated and a possible lessening of competition in 71 others. The CIBC-TD merger, in contrast, would have resulted in a substantial lessening of competition in 36 of the 189 common markets and a possible lessening of competition in a further 53.

The bureau also examined the market for business operating loans between $1 million and $5 million and declared the relevant market to be provincial in scope. Here, the bureau found that the Royal-BMO merger would have caused a substantial lessening of competition in all of the British Columbia, Saskatchewan, Manitoba, Ontario, and Nova Scotia markets. The CIBC-TD merger would have had a lesser effect, producing a substantial lessening of competition only in Prince Edward Island, Yukon, and the Northwest Territories.

Is the Competition Test an End or Beginning?

The Competition Bureau's review identified the competition problems that would have needed resolution if it were to approve the two proposed mergers. Usually the bureau's reviews of merger applications continue the process, considering and negotiating remedies. If the merging parties commit themselves to remedies that overcome all the bureau's concerns, the merger can proceed. The divestment of parts of the combined business offers an obvious and frequently used solution. (To

allow its takeover to go through, for example, TD undertook to divest itself of Canada Trust's MasterCard acquiring and issuing operations and a number of its branches.) Given the bureau's concerns, what would have been needed to have allowed the 1998 mergers to proceed?

The banks surely anticipated the need for remedies in the securities business when they first contemplated the mergers. The steps needed for the CIBC-TD merger would have been relatively minor, requiring divestment of brokerage offices in just a few markets. The remedy for the Royal-BMO merger needed to be more drastic. Across-the-board divestments were necessary in virtually all markets where both securities subsidiaries operated. Still, this would not have been an obstacle if, as was likely, the banks had been prepared to divest themselves of one or the other of Nesbitt Burns and RBC Dominion as a price for the merger.

For the Royal-BMO proposal to have gone forward, the merged bank would have had to remain within the MasterCard empire and sell off its Visa interest. Such a step would certainly have appeared feasible for the card issuing part of the business. Potential purchasers included, in addition to other Visa members, monoline issuers from the United States seeking to expand into Canada.

The market for credit card acquiring appeared to raise more difficult issues. The purchaser of a divested acquiring business would need sufficient scale to absorb such a major operation and also be able to establish the business relationships with merchants. The outlook in this market has changed since the time of the merger review. The acquisition of Canada Trust's acquiring business by First Data suggests that specialized monolines may be potential buyers of acquiring businesses. In addition, BMO and the Royal gained approval for Moneris (as a joint subsidiary) to acquire both MasterCard and Visa transactions on their behalf. While this move by itself did not affect the market shares for acquiring in either of the two credit card networks, it did combine two competitors in the primary acquiring market. Significantly, it gained approval. Although those developments suggest that the problems in acquiring activities may appear less difficult than at the time of the proposals, the bureau did raise concern about Royal-BMO dominance of MasterCard if former Royal customers decided to stay with the merged bank.

Branch market activities appear to pose the largest problems because of the substantial scale of the divestment required.

Branch market activities appear to pose the largest problems because of the substantial scale of the divestment required. The Royal-BMO merger, for example, would have required the disposal of branches in at least 104 markets, with the sale of multiple branches in some markets, to meet the bureau's thresholds. Although branches might possibly be sold in groups to different buyers, purchasers cannot buy branches just for their consumer banking business. They must also establish business relationships to overcome the bureau's concerns about business transactions accounts and loans.

Who Would Buy?

Who would likely be willing and qualified buyers for divestments? The most likely candidates include credit unions and foreign banks wishing to increase their presence. In neither group are there likely to be enough sufficiently qualified buyers who will come forward.

Credit Unions and Caisses Populaires

Credit unions and *caisses populaires* — deposit-taking institutions cooperatively owned by their customers — are limited as buyers by their decentralized organization. Local units are autonomous, and only a few have more than one office. Provincial centrals — themselves cooperatives formed by local unions — coordinate many of the locals' activities. The provincial centrals differ in their goals and their strength from province to province. A national organization provides common services to the central and promotes common policies, but does not deal directly with consumers and businesses.

Certainly the strong presence of *caisses* in Quebec and credit unions in British Columbia and Saskatchewan has already helped to sustain competition in those markets. Some credit unions have recently shown a willingness to expand their local networks by buying bank branches in British Columbia, Alberta, and Saskatchewan. Individual locals will undoubtedly be interested in buying some branches. Provincial centrals may encourage the conversion of former bank branches into new locals.

The credit union system can likely provide some help with bank divestment under present circumstances, but it is not likely to be the entire solution.

The credit union system can likely provide some help with bank divestment under present circumstances, but it is not likely to be the entire solution. Credit unions are primarily oriented toward serving individual consumers and would need to switch their focus toward serving business in order to overcome some of the concerns about competition. The uneven development of cooperative institutions across the country also rules them out as significant buyers of divested branches in many areas, especially in Ontario, with its large number of problem markets. Also, no part of the system has the scale or national scope to resolve the problems of credit card acquiring.

This situation could possibly change. The new legislation permits the chartering of a federally regulated association that would have all the powers of a federal financial institution, including the powers to operate nationally in dealing with consumers and businesses. Such an association could be owned by either the Credit Union Central of Canada, two or more provincial centrals, or ten credit unions coming from at least two provinces. Such an alternative may be an attractive way for credit unions to expand their scope. If credit unions follow this route, they may become more significant purchasers of the branches and other businesses that big banks will need to divest themselves of if they wish to merge.

Foreign Banks

Foreign banks can now do business in Canada through two channels. Some 36 foreign banks operate in Canada through their stand-alone subsidiaries, which can carry on the same business as the major banks. These subsidiaries were constrained in size through rules on concentrated ownership that limited any party to no more than 65 percent of the ownership of any bank with equity of $750 million or more. That limit rises to $1 billion with the passage of the proposed financial legislation. The law also provides that the minister of finance can exempt a foreign bank from this restriction and has indicated to foreign banks that their Canadian

subsidiaries can continue to be wholly owned. Nevertheless, the presence of such a rule, whatever the assurances, will still influence the perceptions of foreign banks.

The experience of foreign bank subsidiaries in Canada has not been favorable. Many have found it difficult to build a branch network *de novo*, and some, finding it unprofitable, have left. HSBC, the largest foreign bank in Canada, has 138 branches and accounts for 3 percent of the total bank assets in Canada. Part of its success can be attributed to its takeover of the Bank of British Columbia and the Continental Bank and their branch networks in the early 1980s. No other foreign subsidiary, however, has more than 0.7 percent of bank assets in Canada.

Foreign banks can also operate through branch offices. These branches avoid many of the costs of stand-alone subsidiaries in that they are integrated parts of the foreign parent and are subject to less Canadian regulation. As a condition for entry, Canadian authorities restricted such branches to wholesale business, preventing them from holding deposits less than $150,000. To date, six foreign banks use branches for doing business in Canada.

Foreign branches can provide only a limited market for the businesses that merging banks will need to divest themselves of. Although branches could become bases for acquiring credit card transactions, the $150,000 floor on their deposit business would prevent them from dealing with many small businesses and providing banking services for consumers. While divestment to foreign bank subsidiaries would avoid those problems, so far foreign banks other than HSBC have shown little interest in expanding their branch networks.

Options with the Status Quo

The development of the Canadian banking system may be at an impasse.

The development of the Canadian banking system may be at an impasse. If policymakers allow mergers to move forward without other changes, they will direct Canadian banking down Bay Street — internationally competitive, but perhaps lacking adequate competition in markets for the services Canadians will need. If they do not allow the mergers to move forward, they will have opted, possibly by default, for Main Street — meeting domestic needs but too small to compete internationally. Exploring the consequences of each option may help to clarify the choice. If neither option is attractive, policymakers need to search for other routes.

Bay Street

Following the Bay Street route would mean allowing mergers among Canada's largest banks to proceed despite concerns over their competitive impact in domestic banking markets. Canada could follow this route by waiving the competition review for bank mergers, as was done for the airlines, or by lowering the standards to be applied.[12] Such a choice has precedents in countries similar to Canada in terms of their openness and small population base.

12 For an expression of this view, see Neufeld 2000.

Both the Netherlands and Switzerland permitted mergers among their major banks; both are now home to some of the world's largest banks. Yet the parallels with Canada are not perfect. Both countries had numerous local institutions that served consumer needs. In addition, much of the size of their banks was based on international rather than domestic business. Both of the two largest Swiss banks, Union Bank of Switzerland and Crédit Suisse, have more than 70 percent of their assets overseas, while ABN-AMRO, the largest Dutch bank, has 60 percent of its assets overseas. The major Canadian banks all hold less than 50 percent of their assets internationally.

The idea behind for the Bay Street view seems pretty clear: Canada risks losing its internationally competitive banks. Many believe that the trends in world banking mean that size will be critical to global banks, and size can be achieved only through mergers. They believe that the failure of Canadian banks to keep up will confine them to being regional banks at best. This relative decline of Canadian banks would have substantial consequences for the Canadian economy through reducing the opportunities for Canadians to participate as employees and shareholders of local firms with global presences.

The relative decline of Canadian banks would have substantial consequences for the Canadian economy.

The Bay Street route gains credibility from the information and communications revolution that appears to be transforming world banking and finance. Many consumers have already adopted telephone and internet banking, reducing their dependence on local branches. The cast of competitors for local markets is beginning to extend to institutions without a physical presence. The existence of specialized firms and other competitors may alleviate the concerns about lack of competition in some banking markets. Yet technology has not swept away all concerns about competition. ING Bank and Citizen's Bank — Canada's exclusively telephone and Internet banks — account for only 0.3 percent of banking assets, and all the big five banks still maintain extensive branch networks for serving their customers.[13] It still may be premature to expect technology to answer all the concerns about the loss of competition.

The Bay Street route faces a number of risks. Evolving communication and information technology may already have left Canadian banks behind in a race in which five to ten megabanks may have come to dominate world banking, and in which even mergers will fail to create internationally competitive banks. Japan's banks clearly demonstrate that size is not all that matters; its banks, which have dominated world banking tables, are now being restructured in an effort to bring the country's ailing banking system back to health. Larger banks pose problems for regulators. They raise the stakes, and when they go bad they reduce the regulator's options.

Easing the standards for the banking sector under competition law may produce undesirable side effects for the banks themselves. Most relevant is the threat of a political backlash to mergers. Canadians already appear to distrust banks and bankers and may object to greater concentration. Like the situation in the airline industry, in which the "rescue" of a fragile competitor created little

13 Even with the introduction of new technologies, the number of bank branches has actually increased by over 10 percent from 1990 to 2000. See Canadian Bankers Association, *Fast Facts* (June 13, 2000) and *Bank Facts* (1992).

goodwill, the dilution of competition rules in the banking industry would be interpreted more clearly as driven by the corporate strategies of the banks themselves. In response, policymakers may hobble large banks with more sweeping government intrusion in their business. A real danger for the banks from such a step would be a movement toward greater public scrutiny and direct regulatory intervention into their business. Banks may find that branch closings will require approval, offerings of small business loans will be mandated, and service charges will be regulated.[14] Though such measures will be costly to the banks and the economy as a whole, bank bashing is in style and may win the day.

Main Street

To follow the Main Street route would be to continue the freeze on bank mergers at the expense of banks' hopes for the larger size they feel they need to make them competitive on the world stage. Canada could follow this route by maintaining the unwritten "big shall not buy big" policy, or — maintaining the spirit of that policy — by not giving proposed mergers a chance by halting the merger process without considering possible remedies for the problems of competition.

The case for the Main Street route may be strengthened because there is no balance of evidence indicating that size is critical for a bank's success.

The case for the Main Street route may be strengthened because there is no balance of evidence indicating that size is critical for a bank's success. Disagreement persists even among the banking community. Some bankers believe that their banks must be big to prosper; as a result, they pursue mergers. Others disagree; they choose the strategy of developing specialized areas of expertise. Still, the massive scale of recent investments in information technology may be shifting the balance. Many believe that the size needed to support such investments may be creating a global banking market dominated by 15 to 20 megabanks.

Continuing along Main Street would leave Canada in limited company. Major mergers have been taking place in Japan and the United States, and within and across the European Union countries. Australia stands out in resisting the trend toward fewer and larger banks.

The Main Street route also faces risks. If Canadian banks are unable to support the scale of investment required to keep up with emerging banking technology, denying mergers may only briefly support efficient service to domestic markets. As Canadian banks fall short of best banking practices in the longer run, Canadian consumers and businesses may find their banking needs poorly served.

Are There Side Alleys Off Main Street?

Is the Main Street route for Canadian banks as bleak as described above? Could the banks not find ways other than mergers to gain the size they need? Main Street certainly does not rule out other strategies, such as internal growth, alliances with other international banks, or mergers or takeovers of non-Canadian banks. All of

14 Bill C-8 has already moved in this direction. Notice, though not approval, will be required for branch closure. The federal government also gains the authority to regulate the provision of low-cost accounts. It expressed the hope that the banks would provide such accounts voluntarily, without the need for regulation.

these represent possible growth paths, but all have shortcomings that make them less effective than domestic mergers as routes to critical size.

Internal Growth

Internal growth may appear, at least in concept, to be an alternative to domestic mergers. The recent experience of the world's largest banks presented in Table 3 suggests, however, that they have relied significantly on mergers to increase their asset size. Stiroh and Poole reinforce the importance of mergers in US banking, finding that "the increased concentration of banking assets among the largest bank holding companies in the 1990s reflects the steady stream of mergers and acquisitions that so dramatically changed these firms," and that "internal growth was not an important part of the strategies of the largest [bank holding companies]" (2000, 5). Although internal growth may appear to offer banks an escape from their fate under Main Street, it may in practice be nothing more than a faint hope.

Strategic Alliances

Strategic alliances might allow Canadian banks to become part of a larger group with the size needed to compete in international banking activities.

Strategic alliances might allow Canadian banks to become part of a larger group with the size needed to compete in international banking activities. An important element of any such alliance must be a commitment by all partners to make the alliance work. Without such commitments, partners would be unwilling to commit resources to the alliance, fearing that other members would fail to do the same or would even withdraw. One way of strengthening such a commitment would be through the exchange of shares. If the share exchange were significant, each partner would share to some degree in the success of the other, and thus both would be more willing to commit themselves to their joint endeavors.

Up to now, Canadian banks have not been appealing partners in such alliances because the 10 percent ceiling to any party's interest in their ownership limited their ability to make significant share exchanges. This limitation has become less restrictive with the proposed relaxation of the ownership restrictions in Bill C-8. By allowing a single party's ownership to rise to 20 percent, the new rule offers scope for significant share exchanges between Canadian banks and prospective alliance partners.

Alliances, like internal growth, offer banks a possible side alley out of Main Street's traffic clogs. But, like internal growth, alliances may show more promise than practicality. Alliances have not been significant forces in international banking. Moreover, domestic experience with them casts doubts on their prospects for international success. One study of alliances, for example, concludes that they "are frequently subject to high instability, poor performance and premature dissolution" (Parkhe 1993, 301, quoted in Santomero and Eckles 2000, 17).

Takeovers and Mergers

The possibility of direct ownership links through mergers with or takeovers of foreign banks may be another strategy for banks to gain the size necessary to be

internationally competitive. These approaches, however, also have their practical limitations.

Canadian banks have already used the takeover strategy. BMO expanded into the United States through the takeover of Harris Bank some 20 years ago, and the Royal has just recently acquired several US banks. This strategy is severely constrained, however, by the scale of the target banks that Canadian banks can take over and digest. While the Royal's most recent takeover of two US banks may have extended its entry into the US market, the targets themselves were medium-sized banks with regionally concentrated business.

Mergers present a different set of problems. The offspring of a merger between a Canadian bank and a foreign bank must meet stringent conditions — it must essentially conform to the requirements for a Canadian bank —to continue operating in Canada. Although these requirements may not absolutely rule out such a merger, they may be unacceptable to the owners of the potential merger target or to its home country regulators.[15]

The Prospects on Other Paths

Advocates of Main Street can correctly point out that choosing it rules out only mergers among large Canadian banks, leaving other possible paths by which Canadian banks might grow. Such a statement needs to be tempered by recognition that the other paths present difficulties as strategies for growth. Though Main Street does not absolutely rule out banks' further growth, it does close off the tested strategy of domestic mergers for attaining greater size.

A Possible Escape

Before committing themselves to either Bay Street or Main Street, policymakers should search for other options. This paper proposes a third route — the use of reciprocal entry agreements.

Neither domestic nor foreign competition appears sufficient under current conditions to overcome the competition concerns raised by the mergers of major banks. Thus, before committing themselves to either Bay Street or Main Street, policymakers should search for other options. This paper proposes a third route — the use of reciprocal entry agreements[16] — which could permit foreign banks to supply more effectively the competitive force that mergers between Canadian banks threaten to lose. We might call this third option "Reciprocity Road."

Foreign banks today face obstacles arising from the restrictions under which they can enter and operate in the Canadian market. Their subsidiaries are hampered by the costly corporate trappings of a stand-alone subsidiary, with its separate management and dedicated capital. Moreover, the minimum deposit requirements limit them in serving retail consumer and small business markets, the areas of greatest competitive concern.

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15 Many countries that lack Canada's limits on bank ownership do have review procedures for ownership changes through which their banking authorities could reject a merger if they viewed the loss of a significant national bank unfavorably.

16 The ability to use reciprocal entry agreements would build on the recent measures that permit foreign banks to operate branches in Canada on a restricted basis.

These restrictions are justified by the primary objective of prudential regulation: protection of small depositors. The subsidiary option places any retail operations in Canada under the oversight of the Canadian regulator, on the same footing as domestic banks. The branch option provides business opportunities in Canada in areas where prudential concerns are less significant. Any alternative allowing greater entry into retail deposit-taking should be subject to comparable oversight as exists for domestic banks.

Reciprocity Road — that is, encouraging reciprocal entry agreements with other countries — could provide a way out of this conflict. Such agreements would allow each party's banks to offer full banking services through branches in the other's banking markets. The agreements could take various forms. At one extreme would be a full regulatory union of the sort binding the banking markets in the European Union. Another alternative would be less formal, bilateral agreements or even a unilateral declaration of terms for entry into Canadian banking.

Following this road could substantially expand the scope for foreign banking activities in Canada. It would overcome the current problems of the limited powers of foreign branches and the need for foreign banks to establish subsidiaries to engage in retail banking. In effect, foreign banks would be able to conduct a full range of banking activities in Canada. Such an agreement would widen the group of buyers for any divestitures that might be required of Canadian banks intending to merge.

This route would raise a host of questions. Under reciprocal agreements, who would regulate a bank's activities across national boundaries — home or foreign authorities? Would banks' activities in foreign countries be subject to double regulation? Or would they slip through the cracks, with no regulation at all? Are differences in regulation across countries so great that regulators could never agree on a common set of rules? Is the devil in the details so that such agreements, however appealing in principle, would never work in practice? We need to consider these questions.

The Single Banking Market: Mutual Recognition at Work

Many of the answers about the practicality of reciprocal agreements in banking can be found in the workings of the European Union's single banking market.

The most challenging of the questions posed above seems to be the last one: Can reciprocal agreements work in practice? If they cannot, why waste any effort in considering them? Fortunately, such an agreement already exists in the European Union's single banking market that now spans all of Western Europe, an area with a population and gross domestic product (GDP) comparable to that of the United States. Many of the answers about the practicality of reciprocal agreements in banking can be found in the workings of the single banking market.

At the heart of the European Union's single banking market lies the principle of "mutual recognition."[17] This principle requires host countries to allow banks from other members to carry on "banking" activities in their domestic banking markets

17 The principle of mutual recognition is embodied in the governing framework of the European Union's Second Banking Directive of 1989. That document established the framework for developing a common market in banking services.

Box 1: *Banking Activities Permitted in the European Union*

- Deposit taking and other forms of borrowing.
- Lending (including consumer credit, mortgage credit, factoring, invoice discounting, and trade finance).
- Financial leasing.
- Providing money transmission services.
- Providing payments services, including credit cards, electronic funds transfer, point of sale, travelers cheques, and bank drafts.
- Providing guarantees and commitments.
- Trading on their own account or for customers in money market instruments, foreign exchange, financial futures and options, exchange and interest rate instruments, and securities.
- Participating in share issues and providing services related to such issues (for shares, bonds, and other securities), including corporate advice and arranging mergers and acquisitions.
- Money brokering.
- Offering portfolio management and advice.
- Safekeeping securities.
- Offering credit reference services.
- Offering safe-custody services.

Source: Murphy 2000.

under home country rules, subject to the regulation and supervision of home country authorities. The directive also delineates the activities subject to mutual recognition by defining banking as the activities shown in Box 1. A host country in the European Union, for example, must allow other members' banks to carry out the permitted activity of leasing regardless of its own domestic rules. On the other hand, a host country is not bound to permit foreign banks to sell auto insurance in their branches, even though they may be allowed to in their home markets.

One danger inherent in mutual recognition is the possibility that members may try to give their national banks a competitive advantage elsewhere in the European Union through setting lax prudential standards. By doing so, they would allow their banks to operate subject to less onerous requirements than their competition. The risks and dangers of a lighter approach to regulation would be shifted to customers and regulators elsewhere in the union who would bear the costs of an institution's failure.

The European Union overcame the costs of such a race to the bottom in safety and soundness by, first, limiting the scope of mutual recognition to defined "banking" activities; second, establishing minimum capital requirements that apply across the entire market; and, third, placing responsibility with home country authorities for the insurance coverage of deposits collected in foreign markets.

Through the Second Banking Directive's definition of banking activities, the European Union achieved a delicate balance. On the one hand, it avoided the risk of giving member countries a *carte blanche* to favor their banks throughout the market by adopting a broad definition of permitted activities. At the same time, it encouraged competition by spurring member countries to allow their banks to

participate in more banking activities in order to prevent their being at a competitive disadvantage, especially in their home market.

The European Union's framework also deals with the danger of loose prudential standards by setting minimum standards in key areas. In particular, a series of directives established minimum standards for member countries with respect to the definition of bank capital ("Directive on the Own Funds of Credit Institutions"), capital adequacy ("Directive on a Solvency Ratio for Credit Institutions"), and large credit exposures ("Directive on the Monitoring and Control of Large Exposures of Credit Institutions"). The two capital directives follow the practice of most industrialized countries, including Canada and the United States, by following the international capital standards set by the so-called Basel Committee of the Bank for International Settlements.

The final element of the single banking market consists of its deposit insurance arrangements. Here the European Union faced a thorny problem. Before the single banking market, each member country had developed its own deposit insurance arrangements to suit its domestic needs. Later, some form of deposit insurance coverage became necessary to protect customers of institutions operating outside their home market. Without it, institutions would have found it difficult to compete in other countries' retail markets. The host country, however, would have found it difficult to insure the deposits of foreign institutions operating in its market because it would have been protecting claims of institutions it could neither supervise nor control. In its "Directive on Deposit Protection Schemes," the European Union avoided both dangers by making home countries responsible for insuring all the retail deposits of their banks throughout the entire union. This approach gave foreign (host country) customers protection while placing responsibility with the home authorities — those most able to supervise and control.

This regulatory union in banking now offers EU citizens several benefits. It removes significant obstacles to new sources of competition in national markets and has the potential to ease the conflict between domestic competition and size. It also expands the opportunities for its members' banking institutions by freeing entry into other members' markets.

Options for Canada

The most comprehensive approach to regulatory reform would be to expand the financial market provisions of the NAFTA.

If the EU regulatory union eased the conflicts facing European policymakers, how might Canada gain the same benefits? There are many possible ways. The most comprehensive approach would be to expand the financial market provisions of the North American Free Trade Agreement (NAFTA) into a true single banking market. A simpler approach would be for Canada to act alone, making a unilateral declaration that it will give mutual recognition under reciprocal agreements to banks from any countries that meet standards for prudential regulation, supervision, and depositor protection.

A North American Banking Market

To pursue the first approach — a North American banking market or regulatory union — Canada would have to overcome some hurdles.

The hurdles should not be exaggerated; a base for such a union already exists in the NAFTA. Nevertheless, when the Canada-US Free Trade Agreement and then the NAFTA were negotiated, an economic union in banking services was clearly a non-starter. At that time, the Canadian and US banking frameworks differed sharply, making mutual recognition infeasible. Canadian banks could operate across the entire country, through branch networks, while US banks were confined to their home region and, in some cases, to their home state. Canadian banks had just gained entry into the securities business, while the *Glass-Steagall Act* still barred US banks from most securities activities. Settling on home country rules in banking would have given Canadian institutions a strong advantage in the United States that would have been unacceptable to US banks. In turn, Canadian banks would have objected to host country rules because they would have gained very limited powers in the United States for opening up their entire home market to US competitors.[18]

Now conditions in the United States have changed dramatically. The *Gramm-Leach-Bliley Act* of 1999 allowed banks into both the insurance and securities industries, and the *Riegle-Neal Act* of 1994 earlier had removed restrictions on interstate banking, allowing major US banks to become national in scope. With this convergence, the obstacles to a single banking market between Canada and the United States are now more those of desire and determination than practicality. The most difficult step for Canadian authorities will be to capture the interest of the United States, which has much less at stake.

The most difficult step for Canadian authorities will be to capture the interest of the United States, which has much less at stake.

Acting Alone

The pursuit of a North American banking market may not, however, provide a timely enough solution for Canada's banking problems. The timetable for strengthening foreign competition in Canadian banking markets is very short because Canadian banks may feel an urgency to bulk up, hence the allure of the Bay Street route. At the same time, customers, together with the competition authorities, may resist mergers among the big five banks unless they see clear evidence of viable competition; Main Street might seem to offer that safety. The third option — Reciprocity Road — would speed the process by letting Canada simply go it alone, inviting other countries to join in bilateral agreements for reciprocal entry into each other's banking markets.

Such a step may appear drastic at first, putting the interest of Canadian depositors at stake. That need not be the case, however, if the process follows principles similar to those that guided the formation of the EU banking market. To ensure that it does, the declaration of any such bilateral agreement should include four elements:

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18 Canadian consumers and businesses would, of course, benefit from opening up by either approach. There is much evidence suggesting that banking reform in both countries typically involves a balancing of different industry interests.

- Agreement to allow the other country's (that is, the home country's) banks to offer the same services through its branches in Canada as are offered by Canadian banks;
- government commitment from the home country's authorities guaranteeing that deposits in Canada will be covered by deposit insurance that meets minimum standards;
- commitment by both countries to capital standards compatible with the *Basel Accord*; and
- commitment that reciprocal privileges will be granted to Canadian bank branches in the other country.

Such conditions are consistent with the intent to stimulate competition from foreign banks while protecting Canadian banking customers. The first two elements are the most important.

Defining the powers of new entrants in terms of host country rules might appear unbalanced if Canadian banks gained fewer powers abroad than foreign banks gained here.

First, defining the powers of new entrants in terms of host country rules substantially simplifies the situation by avoiding the protracted negotiations involved in an issue-by-issue approach. Such an approach might appear unbalanced if Canadian banks gained fewer powers abroad than foreign banks gained here, but the rough convergence of the US and Canadian systems reduces these concerns *vis-à-vis* the United States. The broad definition of banking powers under the Second Banking Directive also means that there should be few concerns over imbalance with countries in the European Union.

Second, a minimum standard for deposit insurance provisions avoids the danger that Canadian depositors would be overexposed to the regulatory standards and actions of authorities in the banks' home countries, or that Canadian authorities would be responsible for the oversight of branches over which they have neither sufficient information nor enforcement power to control. The condition ensures that the liability for depositor protection is placed with the party responsible for and able to act with respect to the safety and soundness of these banks. The deposit insurance condition also means that host countries need worry less about the quality of the other party's regulation once they obtain a binding commitment from the other to cover any losses to their depositors. Such an assurance substantially expedites the negotiations, and it also expands the range of potential partners to include countries with lower prudential standards than Canada's.

The third and fourth elements are not strictly necessary to foster greater competition in Canadian markets. The capital requirement adds to the force of responsibilities for losses to foreign depositors to prevent a regulatory race to the bottom. The reciprocal entry requirement provides greater business opportunities for Canadian banks in foreign markets.

Conclusion

The options for Canadian banking under the status quo are unappealing. Unless new competitors can overcome the possible dampening effects of mergers, Canada may have to sacrifice either the prospect of robust, internationally competitive banks or vigorous domestic competition. In this *Commentary*, I have proposed removing one of the remaining barriers to foreign competitors in Canada by

establishing reciprocal agreements with other countries, allowing them into retail banking markets through branches.

Time is not on the side of Canadian banks and Canadians. Banking is restructuring worldwide and may soon be unrecognizable.

Like pushing on a string, however, this "Reciprocity Road" proposal permits but does not assure new competition. Time is not on the side of Canadian banks and Canadians. Banking is restructuring worldwide and may soon be unrecognizable.

What can Canadians expect if Canada does adopt reciprocal agreements, with their principle of mutual recognition? Foreign banks will not likely rush to build their presence. The difficulties of starting a branch network, though eased slightly, will still be there. But adopting a policy of mutual recognition will be worthwhile if it expands the range of potential buyers when the time comes for divestments arising from future mergers. Mutual recognition would allow foreign banks to acquire the basis for retail branch networks and integrate them into their worldwide operations. By doing so it would loosen the gridlock that now constricts the future of Canadian banking.

Even without the assurance of its success, Canada should push forward the principle of mutual recognition now. It needs to be in effect when merger proposals come forward. At little cost, Reciprocity Road might be a better choice than either Main Street or Bay Street.

But what if we open this road and no one decides to come? This question alone may be significant. Some suggest that foreign banks show little interest in entering Canadian markets because they are already well served. Some argue that Canadian banking markets are already competitive enough and that the standards applied to bank mergers are just too high. But we can never be sure as long as legal barriers to potential entrants remain. Back-of-the envelope estimates of the costs of such barriers are no substitute for their removal if we really want to find out whether they are real. If, with these changes, we still find few potential buyers for the divested parts of merged banks, we may need to reconsider the competition standards we apply to our markets for banking services.

Frank Zappa, in one of his frequent philosophical moments, is alleged to have said: "You can't be a Real Country unless you have a beer and an airline — it helps if you have some kind of a football team, or some nuclear weapons, but at the very least you need a beer."[19] Frank was close, but he underestimated the national concern with banks. A recent public opinion poll commissioned by the Task Force on the Future of the Canadian Financial Services Sector (the MacKay task force) suggests that Canadians feel more passionately about the national ownership of banks than about the ownership of airlines, the oil and gas industry, or telecommunications companies (Ekos 1998, 51).

Airlines and football preview what we may expect if policymakers follow either of the roads on the present path. If mergers proceed without concern for domestic competition (Bay Street), Canadians may face a replay of our airline debacle. Canada could become the home of national champions competing in the global banking world, but at the expense of Canadian consumers and businesses. If mergers are not allowed (Main Street), banking will follow the path of Canadian football,

19 Outdoor concert, Jones Beach, NY, circa 1984. From Internet web site www.science.uva.nl/~robert/zappa/quote; accessed April 24, 2001.

leaving us a watered-down product kept alive by a quota of imports. All the while, we will keep looking over our shoulders at the happenings in the big league.

Maybe such gloomy fates can be avoided, but neither of the two paths available now will ensure it. To preserve a healthy banking system, Canada may need to make strenuous efforts to open it up in practicable ways. This paper suggests one possible way — establishing reciprocal agreements with other countries.

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